

July 2003

401(k) PLAN SPONSORS UNDER ATTACK

THE U.S. RETIREMENT CRISIS BRINGS CRITICISM - AND LAWSUITS - TO THE PLAN SPONSOR'S DOORSTEP

The U.S. has been struggling with a frightening truth: Americans are not saving enough for their retirement. This fact holds enormous and potentially disastrous consequences, and the country has begun pointing fingers. Who is responsible for this ticking bomb? And more importantly to a litigious society, who is liable? Current events have brought this question to the forefront, and the response from employees and their attorneys, and even U.S. legislators, is that the plan sponsor holds much of the blame.

The Law

Who exactly is responsible for ensuring that U.S. employees sufficiently fund and prepare for their retirement? While employees in participant-directed 401(k) plans are responsible for the selection of their own individual investment choices, The Employee Retirement Income Security Act of 1974 (ERISA) outlines the fiduciary responsibilities of plan sponsors in offering a plan to help participants achieve their retirement goals. According to ERISA, the plan fiduciary (which can include any or all of the individuals from the plan sponsor's investment committee, board of directors, plan trustees, benefits managers, etc.) must:

- Operate the plan in the sole interest of the participants and beneficiaries
- Act for the exclusive purpose of providing benefits to the participant
- Exercise care
- Exercise skill
- Act prudently
- Apply knowledge available at the time
- Rely on experts for available knowledge
- Prudently select experts
- Use defined processes
- Document the process

Plan Sponsors Under Attack

Under the law, every individual who has fiduciary authority for the retirement plan is personally responsible to the full extent of his or her wealth to manage the plan in accordance with these principles. While these guidelines can be used to determine if a fiduciary has acted properly, their lack of specificity presents a scenario for the plan sponsor (and the lawyers who sue them) in which there is no specific list of requirements that absolve the fiduciary from the risk of loss of personal assets. In fact, a plan sponsor's fiduciary obligations to employees outweigh even the firm's fiduciary obligations to its shareholders!

Defining "Prudent"

What exactly does it mean for a plan sponsor to be prudent? Herein lies the fodder for potential courtroom debates. Consider, for example, how a *prudent* plan sponsor would be expected to behave when developing and administering a retirement plan for a group of employees with little or no understanding of investment or retirement principles. Would an enrollment meeting and the ability of participants to change investment options via a Web site be sufficient to satisfy the fiduciary responsibility of a *prudent* plan sponsor? Law firms across the country are preparing to argue "no" as their clients, unprepared for retirement, claim that they were ill-informed and/or misguided by their employer when investing in their retirement plans.

In essence, someone must take the blame for the fact that the average plan participant holds only \$42,000 in his or her retirement account. Two pre-eminent Washington DC attorneys who specialize in class action litigation predict that the ones to hold the blame will be plan sponsors. They offer plan sponsors this wake-up call:

*"We are nearly completed with litigation against tobacco companies. We are just beginning the major litigation against gun companies, and the next big area for litigation- after guns- is going to be suing 401(k) and 403(b) plan sponsors."*¹

Why Now?

Until recently, a couple of circumstances have delayed from scrutiny the effectiveness of 401(k) plans (as currently administered) to fund citizens' retirement. To begin with, the first generation of 401(k) self-directed plan participants is only now reaching the retirement stage, so there has not been

Plan Sponsors Under Attack

enough time to detect any problems with 401(k) plan effectiveness or breaches in fiduciary responsibility by plan sponsors. In addition, the U.S.' most recent bull market worked to hide flaws with participant-directed 401(k) plans, since double-digit returns had many people believing they might retire early and with ease.

In both circumstances, however, today's reality has changed drastically. Not only has the bull market turned into a prolonged bear market, widespread breaches in fiduciary responsibility by plan sponsors have been uncovered. Both turns of event have ignited fear and eventually litigation by U.S. hopeful pre-retirees. Most noteworthy have been the lawsuits filed against the companies Enron and WorldCom. By the time the courts will have settled his case, Enron's former CEO Kenneth Lay is expected to lose his personal assets for his breach of fiduciary responsibility to employees in his company plan.

Sadly, both highly publicized cases have rendered the "prudent" person of today's world to expect unethical and fraudulent actions from companies and individuals across the spectrum. But even more significantly, perhaps, is the impact of this attention on the majority of this country's plan sponsors who are not in fact acting unethically, but with neglect.

But I'm Not in the Business of Running a 401(k) Plan

Plan sponsors would argue that they are simply not in the business of managing 401(k) plans; they are in the business of *running their business*. This attitude and neglect have inadvertently created an ineffective retirement savings process for employees, and plan sponsors will likely feel the backlash when their employees are literally unable to retire at age 65. In the majority of cases, plan sponsors are breaking their fiduciary responsibility by shelving the problem of poor or ineffective employee participation in their retirement plans.

For example, once the Ken Lays of the world have been tried, the more likely case seen in court will be that of a baby boomer who wants to retire but cannot for lack of sufficient retirement funds. Employees like this may sue their employer, not because the sponsor imprudently and unethically forced company stock on the employee (as in the case of Enron and WorldCom and others), but because the employer did not prudently develop a retirement plan that succeeded in helping employees reach retirement goals.

How Can Plan Sponsors Protect Themselves While Supporting their Employees?

First and foremost, today's employers need to accept their vital role in helping employees to retire, by embracing their responsibility as 401(k) plan sponsors and plan fiduciaries. Employers seem to have forgotten that employers' responsibility to plan for employees' retirement is not a concept that has just recently been thrown upon this generation of business owners. In fact, today's 401(k) plan (which relies on employee contributions) is less costly than its predecessor, the defined benefit plan that relies on contributions from the company to fund employees' retirement.

Not only is the 401(k) plan less costly to employers, it provides a critical benefit to employees that is vital to attracting and retaining high-quality staff. Plan sponsors who acknowledge the seriousness and importance of their role as plan sponsor, can take comfort in knowing there are prudent steps to administering the plan that will help to manage fiduciary risk.

Specifically, faced with today's realities of corporate malfeasance and the inability of the average citizen to save appropriately for retirement, the prudent plan sponsor will best minimize fiduciary risk by

- 1) Providing employees with access to unbiased, qualified retirement advice, and
- 2) Performing due diligence on all experts involved with the plan.

Providing Advice

It has finally come time to acknowledge that current and past practices of educating employees to fund for their retirement have not succeeded. Plan participants are making poor investment decisions and are simply not on track to be financially prepared for their retirement by the end of their working years.

Plan Sponsors Under Attack

Traditionally, fear of fiduciary responsibility has kept plan sponsors from correcting this problem by offering advice to their employees. Yet recent media, legal, and governmental attention on, and documentation of, participants' inability to prepare for their own retirement is literally changing this risk equation for employers. Now, one could argue that offering participants access to unbiased, qualified advice is not risky, but a form of risk mitigation: "If plan fiduciaries know – or even strongly suspect – that their participants need help, including investment advice, the responsibility for acting is not avoided by not making a decision... From a legal perspective, the greater risk may be to fail to offer investment advice where it is needed... It is far more likely that fiduciaries will be viewed as having fulfilled their responsibilities where participants are advised by reputable investment organizations to create balanced long-term portfolios." ²

So far, the U.S. legislature has come out to support the role of advice in 401(k) retirement plans. Already new legislation supporting advice delivery has been proposed, and is on the path to becoming law. Specifically, bill HR1000, which has been passed by Congress and awaits approval by the Senate, permits investment managers to provide advice to plan participants for a fee. Additionally, the SunAmerica opinion letter has paved the way for plan providers to offer advice to plan participants by using models from 3rd parties to ensure that advice is in best interest of participants.

Performing Due Diligence on Experts in the Plan

In addition to offering participants access to advice, a prudent plan sponsor will ensure that all parties responsible for managing, administering, contributing, or providing advice to the plan, are acting in the best interest of the plan participant. In the post-Enron era, a prudent person must reasonably expect unethical and fraudulent actions from companies and individuals. The usual practice of narrowly applying due diligence only to investment performance falls short of protecting assets from foreseeable risks - plan sponsors must also perform due diligence to mitigate risk from potential threats such as rogue brokers, inexperienced or sanctioned advisors and the unethical practices of any plan co-fiduciary.

Plan Sponsors Under Attack

Risk management therefore requires verifying the ethical, unbiased and knowledgeable practices of all experts used by the plan, including but not limited to: investment consultants, fiduciary advisors, third-party administrators, enrollers, and call centers that support plan participants. The most prudent of plan sponsors will best mitigate fiduciary risk by performing due diligence of these experts in areas such as the expert's regulatory history, ethical practices, quality of customer service, and knowledge of 401(k) principles.

In Conclusion

The inability of millions of Americans to prepare for their own retirement has developed into a nationwide crisis that is at once political, social and economic. Plan sponsors that accept their share of responsibility in righting this crisis by acting prudently, diligently, and in the best interest of their employees will in return gain the loyalty of their employees, while mitigating the risks facing them in a post-Enron world.

Footnotes:

1. "The Retirement Plan Bomb for Non-Profits" by Mark B Manin; LaRhette Manin Benefits Service Group; Wellesley, MA.
2. Fred Reish; Reish Luftman McDaniel & Reicher law firm; Los Angeles, CA.